



**United Nations  
Economic Commission for Africa**

## **Workshop**

# **Capital flows and current account sustainability in African economies**

Organized by  
Economic and Social Policy Division (ESPD)

**21 – 22 September 2005  
Accra, Ghana**

## **The Role of External Debt in Current Account Sustainability in Uganda 1993/94 – 2004/05**

**Louis Kasekende (Ph.D)  
October 2005**

## Table of Contents

	<b>Pages</b>
Abstract	1
I. Introduction	2
II. The Current Account and Capital Flows	4
2.1 Sustainable current account deficits	6
2.2 Evolution of external debt sustainability analysis	7
III. The Ugandan Experience	9
3.1 Uganda's current account and external debt sustainability	15
IV. Implications of the Analysis for Uganda	21
V. Policy Implications for Africa	23
5.1 Generating a holistic picture of the debt problem	23
5.2 Debt strategy and regular debt sustainability analysis	23
5.3 More concessional resources should be made available	24
5.4 Creditors have responsibilities	24
5.5 Increased capacity to trade: export promotion and diversification	24
5.6 Prudent fiscal and consistent monetary policy management	25
5.7 Country risk and cost of business	25
5.8 External debt as a regional common problem	26
5.9 Aid absorption, governance and MDG's	26
5.10 Financial reform and strong banking systems	26
References	27

## **Abstract**

The work on leading indicators of currency crises by Kaminsky et al, 1997 shows that the potential leading indicators, which worked best in predicting a currency crisis, included measures derived from the capital account, the debt profile and current account variables. In line with this early warning indicator approach, this paper assesses the sustainability of Uganda's external debt and current account position with a view to deriving general policy implications for other African countries at a similar level of development. The evolution of the debt-to-export ratio, external debt, exports, imports, and interest payments within a framework of a dynamic debt model is implemented. Overall, the findings indicate unsustainable current account and foreign debt position. The attainment of sustainability has not been possible due to two related parameters. First, because of the high level of debt stock accumulated in the past. Second because import values are more than double those of exports. Most importantly, the recently suggested methodology of determining a country's DSA that jointly uses a country's policy performance based ranking system and the debt stock and flow indicators suggests that debt sustainability remains a critical issue. In view of Uganda's experience, this paper proposes a number of measures to ensure external debt and current account sustainability in Africa. The measures to generate sustainability require an improvement in debt flow data collection, debt strategy implementation, more concessional resource flows, creditor responsibility, increased capacity to trade (export), prudent fiscal management, improvements in governance and accountability, reduction of country risk and the strengthening of African financial sectors.

**KEY WORDS:** Current account, external debt and sustainability

## I. Introduction

Most African economies have reduced considerably macroeconomic imbalances and economic distortions and have shifted to market-based price setting mechanisms. These economies have also moved towards market allocation of resources resulting into improved performance. An examination of the ESAF and PRGF countries over the period 1991-1995 and 2000-2004 shows a number of improvements. For example, many countries have registered high growth rates. Inflation rates have reduced from an average of 44 percent in the 1991-1995 period to 10.4 percent over 2000-2004 period. Over the same period, the reserves increased in terms of months of imports of goods and services coverage from 3.5 to 6.0. Finally, incomes per capita increased from stagnant levels over the 1991-1995 period to post average growth rates of 2.1 percent per annum over the 2000-2004 period (IMF, 2005a,b,c)

However, despite considerable macroeconomic achievements, African economies still face with persistent current account deficits. It is in this vein that it has been proposed that African countries can learn from experiences of other economies and identify the characteristics of imbalances that may not be sustainable (Wachtel, 1998). Identification of unsustainable balances is important in building institutional arrangements that can help an economy avoid macroeconomic problems. The sustainability of the current account and external debt is critical because countries that have experienced exchange rate crises have also been associated with large imbalances. In some of these countries, economic growth and real exchange rate appreciation easily led to increases in the size of current account deficits. Summers (1996) argued that attention should be paid to any current account deficit in excess of 5 percent of GDP, particularly if it is financed in a manner likely to lead to rapid reversals. While large deficits can persist, an imbalance is unsustainable if it is large, national savings are low and the financing cannot be sustained over a long period.

Kaminsky, Lizondo and Reinhart (1997) examined the empirical evidence on currency crises and discussed the alternative approaches used in providing early indications of crises. The list of potential leading indicators, which appear to have worked best and which are directly related to external sustainability include capital account measures, debt profile indicators, current account, international variables and fiscal variables<sup>1</sup>:

Three main conclusions are arrived at regarding early warning signals. First, an effective warning system should consider a broad variety of indicators; Second, some of the individual variables that are useful indicators of crises include international reserves, the real exchange

---

<sup>1</sup> *Capital account* variables include international reserves, capital flows, short-term capital flows, foreign direct investment, and the differential between domestic and foreign interest rates. The level of foreign direct investment is an indicator of sustainability because it represents the most stable form of capital and least likely to be reversed. *Debt profile indicators* include public foreign debt, total foreign debt, short-term debt, share of debt classified by type of creditor and by interest structure, debt service and foreign aid. In practical terms indicators relate to foreign debt to GDP ratio and the total debt or debt service to export ratios. These debt ratios are important in determining sustainability because their magnitudes affect the size of payment outflows. *Current account* measures are the real exchange rate, the current account balance, the trade balance, exports, imports, the terms of trade, the price of exports, savings and investment. *International variables* include foreign real GDP growth, interest rates and price level. *Fiscal variables*: the fiscal deficit, government consumption and credit to the public sector Kaminsky, et al (1997).

rate, trade balance, export performance, M2/international reserves, real GDP growth, and the fiscal deficit among others. Third, the results suggest that several foreign, political, institutional, and financial variables also have some predictive power in anticipating crises.

Early warning indicators are very important in the context of African countries. Many African countries run current account deficits against a background of trade volatility. In spite of this, many countries strive to attain healthy balance of payments and reduce volatility in interest rates so that investment can increase. Large current account deficits have meant that a number of African countries have had to contend with significant imbalances in government savings and resource flows. The problem with prolonged current account deficits that are unsustainable is that they tend to crowd out domestic savings, generating problems for macroeconomic management. This is especially relevant for countries in which deficits are financed by short-term flows or by significant donor support. Indeed, the effect of capital flows on current account sustainability depends on the levels of the early warning signals such as the type and source of flows, the level of international interest rates and the domestic macroeconomic environment.

In the light of the above, the development and monitoring of early warning indicators for external sustainability is important for many African countries. In particular, the erratic nature of the flows suggests that measures to stabilize capital flows and generate sustainability are important for the development of these countries. To generate sustainability a number of countries will have to contend with critical issues that relate to macroeconomic stability, economic structure, domestic saving and debt management. Tackling these issues is important if African countries are to generate sustainable growth and mobilize resources needed to tackle poverty and meet the Millennium Development Goals (MDG's). As with a number of critical issues, African policy makers will need to design mechanisms to exploit the gains from capital inflows and minimize risks that come with increased financial integration.

Balance of payments statistics and the International Investment Positions (IIP's) together form important parameter considerations in the process of determining external sustainability. In general, movements in the current account of the balance of payments are deeply intertwined with and convey information about the actions and expectations of all market participants in an economy. IIP's on their part provide very comprehensive information for central banks because they serve as inputs in the estimation of the consequences of a lasting external sector surplus or deficit for a country. International Investment Position can also provide information of possible domestic or foreign shocks resulting from external financial assets and liabilities. For these reasons, policy makers have found it important to make use of these statistics to explain external sector developments, their sustainability and impact on the domestic sector and to induce changes through policy actions.

This paper uses Uganda's balance of payments data to examine current account and external debt sustainability. The analysis is then employed as a basis for providing guidance to African policy makers in shaping policies related to managing external debt in a sustainable way.

## II. The Current Account and Capital Flows

To understand the potential threats to sustainability, it is important to decompose the measures of current account<sup>2</sup> balance in three different ways. First, the current account balance can be defined as the difference between national savings and investment. Second, the current account balance as the sum of the resource balance (net exports of goods and services, the current (unilateral) transfers and the factor income balance. Finally, the current account balance is the negative of the capital account balance or more precisely capital inflows less the change in foreign exchange reserves.

The decomposition of the current account imbalance between savings and investment shows how growth in output under an environment of low saving rates and rising investment can explain the widening of the current account balance. Another insight comes from the decomposition into the resource balance, factor income and current transfers. In a number of countries, the resource balance (net exports of goods and non-factor services) and the factor income balance have been in a structural deficit because the countries are net debtors. The interest burden on foreign debt in these countries is the most important cause of large factor income imbalance. Furthermore, unilateral transfers can be large when countries receive significant amount of official grants to support public expenditure. In Africa, Mozambique, Tanzania and Uganda in the category of “good performers” have been recipients of large doses of donor flows (10% of GDP and more). In addition, to official aid, some countries have been recipients of large private transfers while others have received large amounts of private capital as they get integrated into the global financial system. In all of these circumstances, foreign exchange reserves have tended to increase largely as a result of these inflows. This has two risks for the domestic economies, the first arising from the erosion of competitiveness while the other from the risk of a reversal of the flows as the aid financing could dry up.

Capital flows can also be decomposed into the components of total capital inflow or net external borrowing, specifically foreign direct investment, portfolio investment, other private flows and official flows. The composition of the capital account is important because short-term capital inflows can be more easily reversed than long-term flows (Kim and Lee, 2002 and Asiedu, 2004). Indeed equity inflows tend to be more stable than debt creating flows. Most importantly, a current account deficit that is financed by extensive foreign direct investment (FDI) is more sustainable than a deficit financed by short-term portfolio investments, which can be easily liquidated when market conditions and sentiments change. FDI is linked to more long-term investment projects that raise the capital stock of a country and tend to generate revenues that may be important for the future repayment of the foreign debt (Watchel, 1998). However, FDI requires an investment climate that is attractive.

---

<sup>2</sup> A current account is said to be sustainable in the long run when it is consistent with solvency. Solvency requires that the ratio of the net international demand for the country's liabilities (both debt and non debt liabilities) stabilizes at a level compatible with foreigners net demand for these claims on the future income flows (Edwards, 2002).

There is a caveat related to short-term flows, countries with developed capital market structures that are able to allocate capital more efficiently are going to attract more inflows. Capital markets increase allocative efficiency and provide liquidity, creating an environment favourable to foreign capital (Kim and Lee, 2002). However, capital market instruments are also likely to facilitate short-term portfolio flows that can be destabilising. The point is that capital market development increases capital inflows on one hand and can also facilitate their outflow on the other hand. Evidence also indicates that improved macroeconomic environments lead to the development of capital markets (Watchel, 1998).

There are also macroeconomic implications<sup>3</sup> that arise from other private capital inflows because these flows can also increase the liquidity of the domestic banking system in two ways. Either by increasing foreign exchange liquidity thus exchange rate appreciation pressures or by increasing domestic currency if the central bank buys foreign exchange to avoid an appreciation of the exchange rate. In both cases domestic banks could face liquidity problems in the event of a capital outflow. In a nutshell, capital inflows tend to increase the riskiness of domestic banks and generate severe macroeconomic consequences (Kim and Lee, 2002).

Finally, although financing from official sources appears to be less unstable than short-term financing from portfolio inflows, it does not in itself make current account deficits more sustainable (Sun, 2004; Alessandria and Quian, 2005). Indeed, it is the greater reliance on private creditors and lower flows from official sources that appears to signal increasing credit worthiness of a country.

Large capital inflows can lead to serious problems for monetary and exchange rate policy. Increased capital inflows relative to total outflows will improve the current account balance and appreciate the domestic currency, which could worsen competitiveness. Moreover, capital accumulation under economic distortions such as protection of certain sectors does not lead to efficient and sustainable growth. Central banks can limit the effect of such appreciation by buying foreign currency in large amounts, which leads to increases in foreign official reserves. However, while increases in reserves may make current account imbalances appear sustainable in the short run, they prevent the necessary exchange rate adjustment required to reduce in the medium term the loss of competitiveness caused by the real appreciation. An inappropriate exchange rate does not support the required adjustment and may lead to dutch disease problems as in the case of Nigeria in relation to oil exports and Uganda in the case of donor aid. Subsequently, large capital inflows and rising foreign reserves may present a wrong signal about the long-run sustainability of a persistent current account imbalance<sup>4</sup>.

The existence of a large current account deficit has implications for the stability of the domestic financial system (Sun, 2004). First, monetary policy enacted to enable a country to finance a current account deficit can be destabilising for the macro economy with a potential

---

<sup>3</sup> Kasekende (2000) provides an indication of the macroeconomic issues related to large donor inflows. Increased foreign exchange inflows have presented challenges to stability in the foreign exchange market and in the wider area of resultant inflationary pressures.

<sup>4</sup> In the event that investors recognize that such an imbalance is not sustainable, a sudden reversal of capital flows could arise leading to reduction in foreign exchange reserves and generate an exchange rate crisis.

to lead to banking sector crisis. Sharp increases in domestic interest rates introduced to attract and retain capital can lead to financial sector insolvency<sup>5</sup> (firms are unable to pay high rates and will default on existing bank debt). Efforts by banks to finance their activities can also generate a foreign exchange crisis. With a current account deficit, domestic banks can borrow abroad to provide financing, but easy access to funds leads to poor lending and to severe difficulties when the exchange rate depreciates. The prospect of higher world interest rates can generate problems for countries with large amounts of foreign debt as they experience an increase in their debt and current account balances. Higher world interest rates also reduce net capital inflows leading to loss in foreign exchange reserves.

A healthy domestic financial sector is therefore the key to avoiding problems associated with capital flows and to enable developing countries to attain sustainable current account deficits. Weak banking systems reduce the willingness of foreign investors to hold portfolio or fixed assets in a country. The quality of the banking system and the efficiency of financial intermediation are foundations for economic and financial sector stability, the ability to withstand adverse shocks and the capacity to develop a market economy (Wachtel, 1998).

## 2.1 Sustainable current account deficits

Theoretically, in order to establish the links between private and public savings on the one hand and current accounts and the impact of real interest rates differentials on exchange rates on the other, it is important to abstract from the complex links between fiscal policy and the level of capacity utilization, as well as from the effect of international interest rate differentials on exchange rates and capital flows (Malcolm and Fabio, 1998). However, the implied question of the extent to which changes in the fiscal position may be offset by opposing changes in the net private savings ought to be addressed. Let us consider an expansionary fiscal policy in the home country (which effectively represents a decrease in government savings). This alters the domestic savings investment gap, spurring an excess world demand for savings (only partially offset domestically). The increased home demand for savings must be satisfied by the inflow of foreign capital, but the only way for this capital to be effected is by a shift of the home country's current account into a deficit. One possibility is that this movement is accomplished by a real appreciation of the domestic currency. In the longer term, the build up of external debt resulting from a home country's fiscal expansion will cause the initial exchange rate appreciation to be reversed. As external debt service rises, the balance on net exports must improve steadily over time to maintain the same current account deficit, and this will require a gradual decline in the home country's real exchange rate. These longer-term stock-flow interactions can be analysed by taking account of the effect of net investment and current account flows on the stocks of productive capital and total wealth (partly provided by the IIP), respectively.

The theoretical considerations however raise practical issues such as the sustainability of these persistent deficits on the current account of the balance of payments. If the deficit is to be financed from the foreign reserves of a country by means of reserve related borrowing, the deficit would obviously be unsustainable. If on the other hand it were financed with

---

<sup>5</sup> It should be noted that there is a possibility of high interest rates arising from mop-up operations.

direct equity investment, it would pose less of a threat to solvency because the dividends paid on such investments would depend on the success and profitability of the investments (Watchel, 1998 and Lane et al, 1998). Moreover, direct investments would bring along with it advantages such as technological transfer, employment creation and managerial skills. Nonetheless, the form of investments financed by foreign funds is of importance. If the resources are invested in fixed property development, the deficit on the current account would be unsustainable compared to when they are channelled into export oriented industries or import substitution production activities. The unsustainability arises because the absence of such proactive investments may lead to a deterioration of the country's terms of trade, further worsening developments on the current account. Moreover, the real interest cost of the capital inflows needs to be equivalent to the return on the additional investment that has resulted from the inflow<sup>6</sup>. Ideally this condition should be based on expected rates of return, although in practice it is generally only possible to measure the real rates of return *ex post facto*.

The other option for a sustainable current account deficit as has already been alluded to is a commensurate increase in the external debt of a country, especially if it is of a long-term nature and is underpinned by low interest rates. This is the option Uganda followed in the years prior to the 1990's. Section III below discusses the decomposition of Uganda's current account into three different ways namely as the difference between national savings and investments, as the sum of three components consisting of net exports of goods and services (resource balance), net income and net current transfers and as the negative of the capital and financial account balance or more precisely the sum of the balance on the capital account, the financial account balance and reserve related items.

## 2.2 Evolution of external debt sustainability analysis

It should be pointed out that the assessment of a country's external debt sustainability was initially carried out using a sustainability target range of 200 to 250 percent for the NPV of debt to exports ratio under the original HIPC framework. This framework was underpinned by the lessons learned from the past experience with debt rescheduling. However, under this framework it was not possible to determine the amount of assistance that was required to improve a country's external debt sustainability before reaching the completion point. This called for a reassessment of assistance at the completion point with an option of topping up assistance in cases where the country would not otherwise be within 10 percentage points of its sustainability target. As a result, it was difficult for creditors to confirm their assistance under the initiative before countries reached the completion point. Subsequently, an improvement to this framework by way of the Enhanced HIPC framework was made.

Under the enhanced HIPC framework, the amount of assistance that would be received at the decision point was fixed. In addition, the threshold to determine the amount of assistance was reduced from 202 to 150 percent for the NPV of debt-to-exports ratio. This change to the framework not only removed the need for a re-assessment of the amount of assistance at the completion point but also provided for reconsideration in cases where there is a fundamental change in the country's economic circumstances as a result of exogenous

---

<sup>6</sup> The real interest rate refers to the nominal rate of interest adjusted for exchange rates and inflation, and it is normally calculated after taking into consideration the effect of taxation.

shocks. These initiatives were an important breakthrough aimed at achieving a one-time reduction in the stock of debt in qualifying countries. While the impact of the HIPC initiative has been significant, it has become clear that debt sustainability remains a complex problem, especially as affected countries try to move forward with development programs which require substantial financing and are subsequently facing increasing debt ratios.

In consideration of the complexity that comes with the dual ambition of trying to achieve debt sustainability for the HIPC's while striving to meet the millennium development goals, the G8 countries have agreed to a proposal to cancel debt owed by HIPC's to IDA, AfDF and the IMF. The proposal is intended to ease debt distress among these countries. However, all these developments have come with challenges especially in regard to macroeconomic management. Some of these challenges have been faced in determining the appropriate policy options for the good performers. In particular, gauging the extent to which fiscal restraint can be used in establishing short-term stability has been the biggest challenge with implications for the potency of monetary policy. The current debate needs to be focussed on establishing whether countries have sufficient fiscal space in their macroeconomic programmes to absorb the additional assistance. Some have argued that perhaps some of the recipients of large donor flows have imposed an unduly restrictive monetary policy stance raising further questions about the optimal fiscal balance in when it comes to highly concessional financing.

These challenges however can be dealt with using different policy options depending on the country specific economic features each of which has some short-term costs. When both the fiscal and external sectors of a country are able to absorb the resources, there is no problem envisaged on the exchange rate as resources can be directed to imports. However, in cases where the fiscal sector can absorb the resources while the external sector is constrained (as in the case of Uganda, Tanzania and Mozambique), concerns about losing export competitiveness crop up. Attempts to address these concerns result in a build up in domestic debt and high interest rates. In instances where the fiscal has low absorptive capacity with the external sector being able to absorb the resources it is possible to direct the resources to the private sector and NGO's. Finally, countries may have both restrained fiscal and external sector absorption in which case the aid should be rejected with a high political cost or else the assistance ends up building reserves. Ghana and Ethiopia are examples. These challenges to ensuring sustainability of the macroeconomic framework continue to exist in developing countries without simple solutions. Any attempts to absorb the additional aid widen the current account deficit or the fiscal deficit and in some cases both (twin deficit problem). These in turn have an impact on earlier successes achieved in controlling inflation premised on fiscal control. The appropriate balance between high public investment, promotion of private sector development and maintaining macroeconomic sustainability therefore warrants some further attention.

Other issues that merit attention are those to do with taking account of poor governance and efficiency in using the resources. The latter is especially crucial in view of the fact that a large chunk of the resources are channelled towards the achievement of the millennium development goals. It is therefore imperative to be able to guide countries with large public debt on how to best make use of the additional resources. Some of the key issues to

consider include ensuring that the composition of assistance is appropriate, and that an optimal balance is struck between recurrent and development public spending.

More recent work (Kraay and Nehru, 2004) illustrated the substantial value added in assessing the quality of policies and the severity of shocks in addition to debt burden indicators when assessing the probability of debt distress of individual countries. Using specific country cases, they demonstrated the fact that some countries had low debt burdens relative to the benchmarks of 150 for debt-to-exports and 205 for debt-to-revenue but still had high probabilities of debt distress owing to either poor policy performance or recent poor growth performance<sup>7</sup>. Similarly, they also showed that some countries were able to bear significantly higher debt burdens without a higher-than-average debt distress probability because of the quality of their policies and the robustness of their economic growth. It has therefore been suggested that a more appropriate methodology for determining a country's DSA that jointly uses the country's policy performance based country-ranking system with the respective debt stock and flow indicators incorporated in country debt sustainability analyses. Thus given a country's performance grouping and the applicable indicative debt burden thresholds applicable to the group ranking, the debt burden indicators such as the NPV of debt-to-exports or debt-to-GDP or debt service-to exports ratio would be determined. The percentage distance from the respective debt burden indicators would then be determined (i.e. the average of the percentage distances from the relevant threshold) and compared with the relative distance of the actual flow indicator (NPV-debt service-to-exports) from its corresponding threshold. These would then show the extent of severity of the debt distress that respective countries face in addition to serving as indicators for determining the composition of assistance (grants and credits to be allocated to the respective country).

The DSA and CPIA are therefore useful to countries in as far as determining the additional external resources a country should source for without creating debt sustainability problems. Consequently, countries with a high CPIA have a higher debt carrying capacity and vice versa for those with low CPIA scores.

### **III. The Ugandan Experience**

The decomposition of Uganda's current account is a good starting point for the analysis of the potential problems in the balance of payments. Table 1 presents the results of the decomposition of the current account. The results show that both saving and investment ratios in terms of GDP increased considerably in the late 90s. Foreign savings financed a significant share of total investment, especially after the freeing of the capital account in 1997. However, part of the increase in total investment was on account of government's divestiture of public enterprises, which started around the middle of the 1990's. This together with the liberalization of the capital account in 1997 and the improved macroeconomic environment explain the rise in investment as a share of GDP from an average of 14.1 percent between 1993/94 and 1996/97 to an average of 18.5 percent

---

<sup>7</sup> The World Bank under its Country Institutional Policy Assessment now seeks to determine the Debt Sustainability of a country based on institutional and policy assessment.

between 1997/98 and 2000/01. Nonetheless, as FDI became an integral part of total investment in Uganda's economy, it has become important to examine the problem of the efficiency of capital utilization, which plays a significant role in ensuring high economic growth as well as in determining the capacity to pay debt. As emphasized by Berthelemy and Soderling (1999), paying too much attention to the amount of investment is not enough since an increase in investment does not automatically lead to higher output. Also, attracting huge amounts of foreign capital without its efficient utilization will create pressures on the BOP and the capacity for paying the external debt (Watchel, 1998).

Table 1 shows that Uganda has had a structural deficit in the resource balance (net exports of goods and services). Although the deficit declined tremendously in 1996/97, from 9.4 percent of GDP the previous fiscal year to a deficit of 3.0 percent of GDP, it resumed its upward trend due to the impact of terms of trade shocks on account of low international prices for coffee exports, which was the main export commodity at the time. After an improvement in 2003/04 due to good performance among non-traditional exports, the deficit widened in 2004/05 partly driven by the appreciation of the Uganda shilling and increasing oil prices. Developments in the income account show a deficit averaging at 2.3 percent in the first three years (1993/94 to 1995/96) and then improving to an average deficit of 1.4 percent of GDP over the next three years (1996/97 to 1998/99) as Uganda had a large part of its external debt forgiven and a part of it rescheduled through the HIPC initiative<sup>8</sup>. The years thereafter (1999/00 to 2004/05) have resulted in the widening of the deficit resulting from higher interest payments on private debt as controls were lifted on the capital account allowing the private sector to contract external debt<sup>9</sup>. The trends in the income account show that Uganda is a net foreign debtor country and the interest cost of the debt (both official and private) accounts for the largest part of the deficit in the income account. However, the interest cost of this debt is expected to decline as government continues to undertake measures to reduce on costs associated with debt financing of its budget by way of contracting foreign debt on only low concessional terms comparable to those of the World Bank, in addition to sourcing for grants.

---

<sup>8</sup> Uganda received the first debt relief amounting to US\$347 million followed by additional relief under the enhanced HIPC equivalent to US\$ 656 million in NPV terms.

<sup>9</sup> The faster increase in imports compared to exports, as a ratio of GDP is an important factor explaining the country's deficit.

**Table 1**  
**Savings, investments, the current account and its financing as a percentage of GDP**

Period	Savings	Investment	Current account inc. grants	Current account excl. grants	Net exports of goods and services	Net income	Net current transfers	Net capital and financial inflows	Reserves and related items
93/94	8.75	13.33	-7.66	-14.27	-13.43	-2.38	8.15	6.94	0.72
94/95	9.46	14.70	-9.69	-15.50	-13.26	-2.12	5.69	7.18	2.51
95/96	9.92	14.09	-9.37	-14.54	-15.39	-2.24	8.26	5.34	4.03
96/97	10.32	14.19	-3.01	-9.41	-6.75	-1.21	4.96	6.07	-3.07
97/98	12.16	16.09	-5.40	-13.09	-10.76	-1.29	6.65	5.55	-0.15
98/99	11.93	19.36	-7.52	-14.83	-12.00	-1.80	6.27	5.51	2.01
99/00	10.87	19.91	-7.00	-13.20	-11.88	-2.36	7.24	5.19	1.81
00/01	12.33	18.53	-4.86	-14.34	-12.57	-3.19	10.90	4.83	0.03
01/02	12.90	19.67	-5.81	-13.57	-14.47	-2.59	11.24	7.38	-1.57
02/03	14.95	20.64	-6.26	-13.54	-14.20	-2.74	10.68	7.11	-0.85
03/04	18.48	21.70	-1.74	-11.24	-13.19	-2.55	14.01	4.56	-2.82
04/05			-3.40	-11.89	-13.63	-2.19	12.42	6.94	-3.54

Source: Bank of Uganda and Uganda Bureau of Statistics

Notes: Other investments include trade credits, loans, currency deposits and other assets.

The third important factor explaining developments in the current account balance are the current transfers. The balance on the current transfers account has been in surplus since 1993/94. Fairly low current transfers in the range of 5 to 7.5 percent as a ratio to GDP excluding 1993/94 and 1995/96 characterized the period from 1993/94 to 1998/99. The period thereafter was marked by higher disbursements of official grants as more donors opted to provide grants as opposed to loans in line with efforts to help Uganda achieve a sustainable external debt position. In addition, there was a rise in private transfer inflows in the form of mainly workers remittances and aid from international aid agencies to non-governmental organizations. Subsequently, the surplus increased as a ratio of GDP to about 11 percent of GDP peaking at 14.01 percent in 2003/04. These transfers have been able to offset a large portion of the deficit from other sub-accounts in the current account.

The last two columns in Table 2 show the evolution of the capital and financial accounts and movements in reserves and reserve related items such as IMF credit and exceptional financing. In the years 1993/94 to 1995/96, Uganda financed the current account deficit through the combined use of savings of non-residents and reserves and related items. Foreign reserves increased substantially thereafter from about 3.7 months of imports of goods and services to 6.1 months as Uganda increasingly financed the deficit on the current account through other forms of capital inflows<sup>10</sup> including foreign direct investment, private debt and public debt.

---

<sup>10</sup> Some of the capital inflows that explained the reserve build up were in form of grants (Aid inflows)

**Table 2**  
**Capital flows to Uganda - (millions of US dollars)**

Period	Current account	Capital and financial account	Of which:			Official assets	Private assets	Official liabilities	Private liabilities	Errors and omissions	Reserves and related items
			Foreign direct investment	Portfolio investments	Other investment						
93/94	-285.39	258.57	59.86	0.00	152.87	0.00	-15.20	162.78	5.30	130.40	-103.57
94/95	-511.48	379.20	109.98	0.00	228.02	0.00	10.39	230.57	-12.94	266.25	-133.97
95/96	-514.95	293.28	113.36	0.00	127.72	0.00	-14.75	171.77	-29.30	295.87	-74.20
96/97	-171.11	345.63	163.00	0.00	129.32	0.00	37.81	140.33	-48.82	-56.63	-117.88
97/98	-356.35	365.93	120.00	0.00	205.38	0.00	-51.15	183.42	73.10	111.34	-120.92
98/99	-451.13	330.47	145.27	0.00	185.20	0.00	-4.98	176.54	13.64	87.03	33.63
99/00	-414.39	307.45	176.55	0.00	130.90	0.00	1.20	123.12	6.59	4.04	102.90
00/01	-275.44	274.01	133.39	0.21	140.41	0.00	-13.19	131.92	21.68	17.90	-16.47
01/02	-339.67	431.68	197.09	0.42	234.17	0.00	12.43	228.35	-6.61	14.26	-106.27
02/03	-392.22	445.42	209.55	1.23	234.63	14.22	-18.10	229.28	9.23	-0.87	-52.33
03/04	-118.43	310.59	214.18	10.42	85.98	2.39	-86.13	147.99	21.74	-9.17	-182.99
04/05	-295.14	602.40	264.46	-1.16	339.09	-11.55	142.81	189.70	18.13	-41.77	-265.49

Source: Bank of Uganda

Additional evidence on the composition of capital flows is shown in Table 2 which also demonstrates the importance of foreign savings in Uganda's balance of payments in form of both foreign direct investment and other investments comprised mostly of loans. The balance on the capital and financial account is shown inclusive of errors and omissions on the assumption that the bulk of the unmeasured inflows consist largely of capital inflows to the private sector. These unrecorded inflows to the private sector include private external debt, trade credit, and portfolio inflows as opposed to current account transactions<sup>11</sup>. In 1993/94, the current account deficit was small (US\$ 285.4 million) financed by mainly public debt and a small amount of foreign direct investment (US\$ 59.9 million) among other private sector capital flows resulting in an increase in reserves and related items<sup>12</sup> worth US\$ 103.6 million. The next two years were marked by a dramatic surge in the current account deficit, which was matched by a large surplus on the capital and financial account as FDI doubled, in addition to other private inflows (as shown by the errors and omissions).

The developments in the BOP highlight two main distinct stages of private capital flows to Uganda. The first stage is that prior to 1998 during which, the capital inflows were mainly in form of FDI. This was followed by the post 1998 phase when in addition to a rise in FDI inflows, other forms of private capital inflows emerged such as investments in the domestic money markets to purchase government securities and equity securities in the Uganda Securities Exchange. The equity securities mainly relate to some of the privatised companies whose shares were floated on the stock exchange. There was also an increase in other investments by non-residents as illustrated by the increase in private sector external debt, currency and deposit liabilities of commercial banks. In the case of commercial banks, the monetary survey shows a rise in the foreign liabilities of banks from US\$ 37.2 million in 1993/94 to an estimate of US\$52.2 million for 2004/05.

On a positive note, financing from official resources in form of loans has been on the decline since 1998/99 mainly due to more emphasis by government on sourcing for grants to limit its external debt after receiving HIPC. In the case of IMF loans, there has been a large decline from disbursements in the range of US\$52.4 million in the first five years to an average of US\$27.3 million in the first three years after 1997/96 and further down to a total of about US\$23 million during the last three years (2001/02 to 2004/05) as the country moved beyond traditional IMF stabilization programmes.

These developments in the balance of payments have resulted in the continued increase of foreign reserves from US\$ 219.3 million in 1993/94 equivalent to only 2.3 months of imports of goods and services to US\$ 1,439.4 million estimated for 2004/05 equivalent to 6.5 months of imports of goods and services. Despite the positive developments, one can not avoid wondering what would have happened to the economy if the all important official flows started to dwindle particularly in view of the fact that there are less loan disbursements in preference to grant financing which increases the risk of donor fatigue. While it is quite

---

<sup>11</sup> The assumption that errors and omissions are part of the capital and financial account is premised on the fact that there was no incentive to the private sector to understate exports or over state imports due to the removal of both foreign exchange controls and controls on the current account. The other justification for this assumption is that official flows such as grants; public debt payments and disbursements are properly recorded.

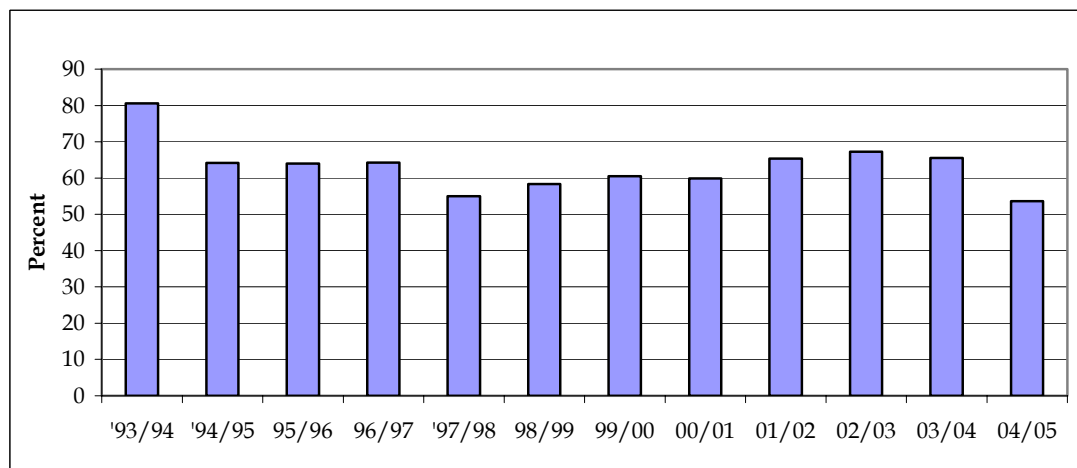
<sup>12</sup> This item includes reserves, IMF purchases and repurchases and exceptional financing.

difficult to have an answer to this question, we adopt an analytical framework that assesses the sustainability of the current account deficit financed by public external debt, as is the case for most HIPC's. In addition, adopting a rather conservative stance the analysis excluded unrequited transfers in the analysis of Uganda's future current account and external debt sustainability.

### 3.1 Uganda's current account and external debt sustainability<sup>13</sup>

Uganda's stock of outstanding and disbursed external debt is estimated at US\$4,464.9 million as at end June 2004. This is an increase of approximately US\$1,465.6 million in nominal stock from US\$2,999.3 million recorded as at end June 1994.

**Figure 1**  
Uganda's debt to GDP ratio - 93/94 to 04/05

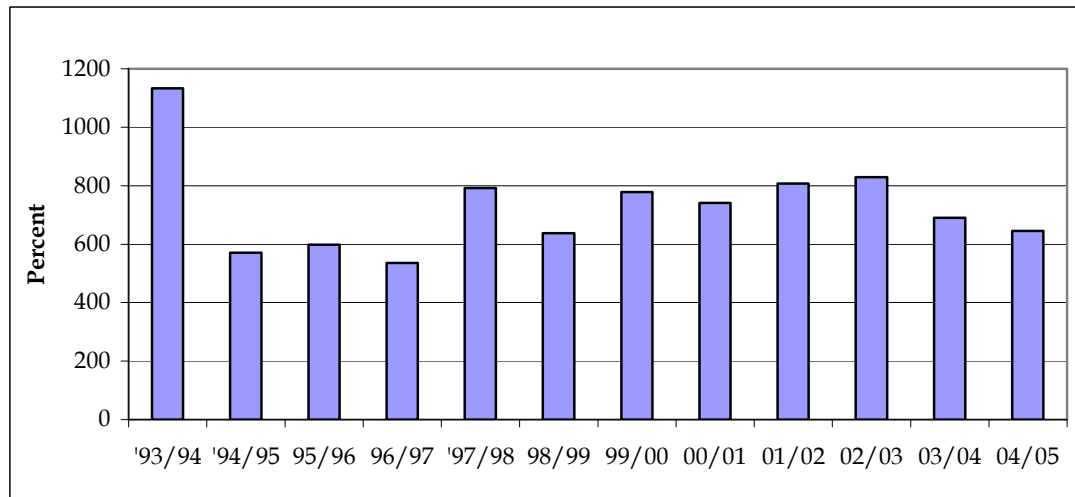


Source: Bank of Uganda

However, the total Debt stock as a ratio of GDP has dropped to 53.6 as at end June 2004 from 80.54 percent registered at the end June 1994. In June 2004, about 89.8 percent of the total external debt was owed to multilateral institutions, 8.5 percent to non-Paris Club bilateral creditors, and 1.6 per cent to Paris Club creditors. The debt to export ratio has been at an average of 730 percent although there has been a downward trend over the last two years (2003/04 and 2004/05) to levels below 700 percent despite a growing debt stock. The decline in the ratio is due to the improvement in export performance attributed to growth among Uganda's non-traditional exports and the recent recovery in world coffee prices.

<sup>13</sup> The investigation of Uganda sustainability is done by the use of Jaime De Pines model.

**Figure 2**  
**Uganda's debt to exports ratio – 93/94 to 04/05**



**Source:** Bank of Uganda

According to the World Bank, a country is regarded as severely indebted if total debt to GNP exceeds 50 percent *or* if total debt to exports exceeds 275 percent. Thus, Uganda's external debt is still unsustainable although the ratio of debt stock to GDP is on a downward trend.

De Pines (1989) used a dynamic debt model based on the BOP identity, to project the debt-to-export ratio in Latin America and Africa during 1986-90 (De Pines 1989). The model was premised on the fact that the fundamentals of debt dynamics are determined by four ratios: interest rate to export growth rate, import growth rate to export growth rate, the initial debt-to-export and the import-to-export ratios. In general, De Pine's model emphasized "the excess import restraint" that is synonymous with "over adjustment<sup>14</sup>". The concept of over adjustment was used to determine how rapidly imports could grow without adversely affecting the debtor country's BOP by enabling it to stay solvent in addition to ensuring a sustainable current account deficit. Consequently, a measure of the amount of extra credit (or extra current account deficit excluding grants) that a debtor country could service to finance additional imports was derived. In this study, since the value of Uganda's imports already far outstrip that of exports, analysis is focused on determining the additional exports required to deliver a declining debt to exports ratio while maintaining the current level of import growth and interest payments on debt.

In this model, the debt-to-export ratio,  $d_t$ , is determined by two parameters: the interest rate-to-export growth ratio  $a$ , and the import growth-to-export growth ratio  $b$  and two initially predetermined variables are  $d_0$  and  $v_0$  (import to export ratio). The parameters  $a$  and  $b$  determine the future evolution of the debt-to-export ratio and the sustainability of the

<sup>14</sup> Here the analysis emphasizes the importance of establishing the difference between the actual and warranted imports, where warranted imports refer to the maximum amount of imports that would still allow the respective country's debt-to-export ratio to decline.

current account. With the total import value at US\$ 1,364.7 million and total export value at US\$ 664.8 million, the initial import-to-export ratio,  $v_0$ , is equal to 2.1. For purposes of analysis based on the availability of data, use is made of aggregates for 1994/95 as the base year for the ten-year period to 2004/05. According to official statistics at the Bank of Uganda, the total debt was US\$ 3,386.9 million in 1994/95. Using this value of debt stock, the initial debt-to-export ratio,  $d_0$ , was 5.09. The other computations from the model are based on constant values of  $a = 0.924$  and  $b = 0.997$  derived as the averages of the ten-year period (See Table 3 below provides the details).

Accordingly, despite a lower import growth compared to the export growth rate ( $b < 1$ ) for Uganda, the debt to export ratio shows an upward trend even when export growth is higher than the interest rate ( $a < 1$ ). This is explained by the failure to ensure the import restraint which measures the ratio of imports to exports derived in the base period and used in the simulations supersedes the upper limit of probable imports or the lower limit of probable exports to ensure current account sustainability. Thus the deficit of the current account and the external debt are unsustainable for the period 1994/95 to 2004/05.

This result is confirmed by other measures of current account sustainability shown in Table 4. The unsustainable nature of the external debt is also confirmed by the debt sustainability analysis for Uganda done by the IMF. The traditional measure of the adequacy of foreign exchange reserves using the stock of reserves in months of imports (of goods and services) is one of such measures. Table 5 shows an upward trend in the reserve cover in months of imports from 2.28 months in 1993/04 to 7.13 months in 2004/05 for Uganda. However, while this measure may indicate capacity to withstand external shocks, it may not show whether the current account is sustainable or not. Other measures include the level of openness of the economy. A more open economy in terms of trade may be less fragile to external imbalances compared to a more closed one because it would ably service its future external debt using the generated foreign currency earnings. A simple measure of openness and thus an indicator of future prospects for repaying external loans is the ratio of the average of exports and imports to GDP. However, this should be qualified only by a diversified export base to safeguard against a decline in this ratio. Uganda's ratio of exports and imports to GDP is about 2 percent although there is limited vertical diversification.

Summers (1995) argued that close attention was required for countries whose current account deficits (including grants) were in excess of 5 percent of GDP particularly if they were financed in a way that could lead to rapid reversals. In the case of Uganda, the ratio of the current account deficit to GDP has been above 5 percent with the exception of 1996/97, 2000/01 and 2003/04. Preliminary estimates for 2004/05 show it may be just below 5 percent of GDP.

**Table 3**  
**Debt to export ratios, 1995/96 – 2004/05**

Variable of interest	'93/94	'94/95	95/96	96/97	'97/98	98/99	99/00	00/01	01/02	02/03	03/04	04/05
		Base Period										
Debt Stock <sup>15</sup>	2999.30	3386.90	3515.80	3660.20	3631.00	3499.60	3580.00	3395.20	3825.21	4215.52	4464.92	4654.62
Exports of goods and services	343.91	664.76	723.31	837.46	633.86	735.14	663.24	677.34	699.02	767.62	1015.88	1198.14
Imports of goods and services	844.18	1364.69	1569.05	1221.90	1343.65	1454.99	1366.44	1389.86	1544.99	1657.42	1914.21	2382.12
Estimated interest rate <sup>16</sup>	0.01	0.02	0.02	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Ratio of interest rate growth to exports growth (a)	0.92	0.53	0.93	0.87	1.34	0.87	1.12	0.99	0.98	0.92	0.76	0.85
Ratio of import growth to export growth (b)	1.00	0.84	1.06	0.67	1.45	0.93	1.04	1.00	1.08	0.98	0.87	1.06
Debt to export <sup>17</sup> ratio		5.09	5.76	6.36	6.92	7.42	7.89	8.31	8.70	9.05	9.37	9.66

Notes: Values derived using 1994/95 ratios of debt to exports and imports to exports  
Source: Authors computations based on De Pines model

<sup>15</sup> The analysis is done for only public debt as opposed to total debt due to the brevity of data on private external debt.

<sup>16</sup> The interest rate is derived as the ratio of total interest on public debt to the debt stock.

<sup>17</sup> Exports of goods and services.

**Table 4**  
**Selected key indicators – 93/95 to 04/05**

Memorandum items	'93/94	'94/95	95/96	96/97	'97/98	98/99	99/00	00/01	01/02	02/03	03/04	04/05 Estimate
Current account balance as a percentage of GDP	-7.66	-9.69	-9.37	-3.01	-5.40	-7.52	-7.00	-4.86	-5.81	-6.26	-1.74	-3.40
Current account balance (excl. grants) as a %age of GDP	-14.27	-15.50	-14.54	-9.41	-13.09	-14.83	-13.20	-14.34	-14.11	-14.42	-11.94	-12.85
BOP overall balance as a percentage of GDP	-0.72	-2.51	-4.03	3.07	0.15	-2.01	-1.81	-0.03	1.57	0.85	2.82	3.54
Total exports and imports to GDP	-15.81	-15.38	-17.64	-7.97	-12.05	-13.79	-14.25	-15.76	-17.05	-16.94	-15.75	-15.82
Ratio of imports to exports	2.45	2.05	2.17	1.46	2.12	1.98	2.06	2.05	2.21	2.16	1.88	1.99
Total debt stock (end of period) as a %age of GDP	80.54	64.16	63.98	64.30	55.04	58.34	60.49	59.91	65.41	67.27	65.57	53.60
Debt service (maturities incl. IMF) as a %age of exports	55.60	29.54	28.78	24.30	37.89	32.31	38.45	24.92	24.43	26.60	25.03	24.21
Debt service (maturities incl. IMF) as a %age of export of goods and services.	42.79	26.35	23.40	19.84	27.41	24.14	26.66	16.86	16.56	17.60	15.94	14.58
Debt service (maturities incl. IMF) as a percentage of GDP	2.78	2.04	1.55	1.54	1.29	1.10	1.14	0.67	0.61	0.67	0.88	0.84
Total external reserves (end of period) in months of imports	3.44	4.95	6.12	7.93	9.57	9.54	9.17	9.42	11.13	12.29	10.36	18.05
Total external reserves (end of period) in months of imports of goods & services	2.28	3.41	3.67	6.11	6.70	6.17	6.32	6.38	6.78	6.98	7.11	6.60
Debt stock to exports of goods ratio (%)	1133.18	571.19	597.89	535.50	792.08	637.29	778.43	740.82	806.95	829.97	689.90	645.33
Total aid to GDP (%)	14.39	12.63	10.62	10.94	12.12	12.17	10.00	7.88	7.01	7.01	9.44	8.94
Direct investment to GDP	1.61	2.08	2.06	2.86	1.82	2.42	2.98	2.35	3.37	3.34	3.15	3.05

Source: Bank of Uganda

The debt-to-export ratios mentioned in Table 3 are simulated using the average export and import growth rates (so parameters  $a$  and  $b$  are held constant) and the values of  $d_0$  and  $v_0$  of the base year in Jaime De Pine's model. However, the values of  $d_0$  and  $v_0$  of each subsequent years are allowed to vary. The model also emphasizes the significance of the *initial export* requirement. The export requirement during 1994/95-2004/05, is evaluated together with the level of export underperformance in each year and is presented in Table 5. From Table 5, it can be concluded that since Uganda is an open economy, with little or no room for import restriction, government can only ensure current account sustainability by pursuing policies that promote a rapid increase in exports.

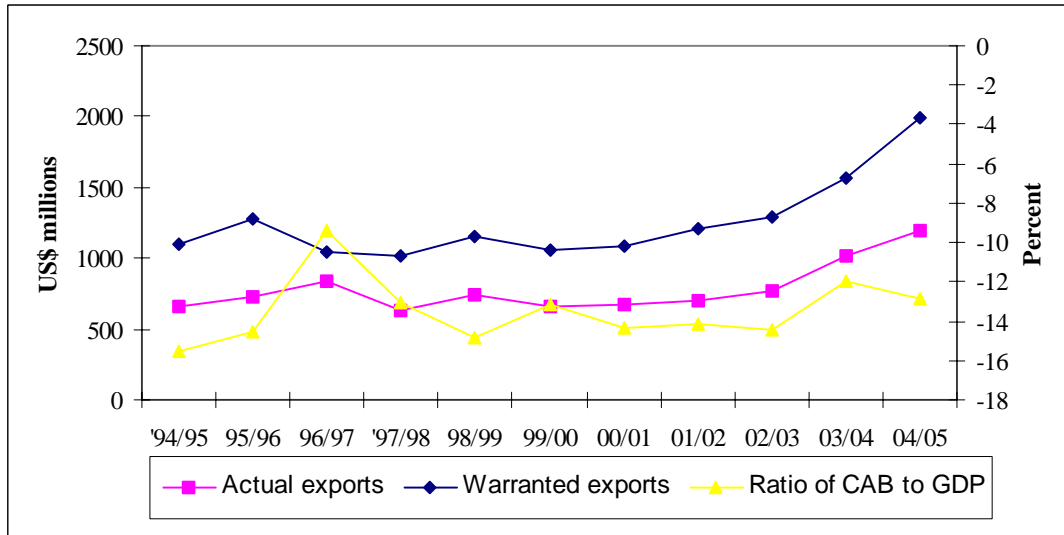
**Table 5**  
**Warranted exports and required export adjustment, 1994/95 – 2004/05**

Period	$d_0$	$v_0$	$X_0$	$M_0$	$a_0$	Critical imports to exports ratio $v$	Warranted exports	Required adjustment in exports
94/95	5.09	2.05	664.76	1371.83	0.95	1.25	1093.36	428.60
95/96	4.86	2.19	723.31	1586.88	0.95	1.24	1276.66	553.35
96/97	4.37	1.51	837.46	1265.72	0.95	1.22	1038.76	201.30
'97/98	5.73	2.05	633.86	1301.11	0.95	1.29	1011.46	377.60
98/99	4.76	1.95	735.14	1434.89	0.95	1.24	1159.07	423.93
99/00	5.40	2.04	663.24	1351.45	0.95	1.27	1064.28	401.03
00/01	5.01	2.01	677.34	1362.19	0.95	1.25	1089.25	411.91
01/02	5.47	2.20	699.02	1540.98	0.95	1.27	1209.98	510.96
02/03	5.49	2.15	767.62	1647.82	0.95	1.27	1292.88	525.26
03/04	4.40	1.87	1015.88	1903.52	0.95	1.22	1560.63	544.75
04/05	3.88	1.98	1198.14	2371.80	0.95	1.19	1986.09	787.95

Source: Bank of Uganda and the author's computations

Table 5 shows all values of  $d_0$ ,  $v_0$ , imports  $M_0$ , and exports  $X_0$  of each year. Based on this information, the adjustment in each year during 1994/95-2004/05 is estimated. Firstly, the critical import-to-export ratio,  $v$ , is derived, the critical ratio  $v$  refers to the initial non-interest current account deficit at which the debt-to-export ratio would have a declining trend. By dividing the corresponding import value  $M_0$  by  $v$ , the warranted export value is computed. The additional exports required each year are then derived as the difference between actual and warranted exports. These show the additional exports required each year to cause a declining trend in the debt to exports ratio and subsequently current account sustainability if the same level of imports and debt interest costs were to be maintained. Figure 1 illustrates the trends in warranted exports and actual imports during 1994/95-2004/05 (the case of  $a = 0.95$ ) and the ratio of the current account balance (excluding grants) to GDP for each year.

**Figure 2**  
**Ratio of current account balance to GDP and warranted and actual exports, 1994/95 – 2004/05**



The actual exports are lower than the warranted exports during the entire period (1994/95 to 2004/05). In 1996/97, actual exports converged towards warranted exports due to a hike in world coffee prices that coincided with the coffee boom in Uganda. However, the low trade and current account deficit level in 1996/97 was a one off followed by a collapse in the coffee prices and the subsequent rise in the deficit on the current account. The government has consequently undertaken measures to narrow the current account deficit by embarking on a Strategic Exports Promotion program (SEP) to boost export performance. As a result there has been some sustained growth in exports with effect from 2002/03 although this is still low compared to what would be required as shown in Table 4. On the other hand, imports have continued to grow on account of high donor flows and more recently, the combined effect of the appreciation of the Uganda shilling and the rising trend in world oil prices. This would not be a source of concern, if the import content were dominated with investment goods since these would lead to increased production. However, a large portion of imports is in form of consumer goods. The influx of cheap consumer goods from the South East Asian countries led by China and Hong Kong pose a threat to the local industrial growth in the era of trade liberalization, as there is little or no room for the use of import restrictions to curb consumer imports.

#### **IV. Implications of the Analysis for Uganda**

The market-oriented reforms resulted into the turning point of improved performance of the Ugandan economy in 1992/93 which has since then been maintained. There is no doubt that the trade and current account liberalization — a key element of the reform process — has made a significant contribution to rapid economic growth and other remarkable achievements during the 1990s. However, concerns remain about the high level of current account deficit. In the foreseeable future, the country will have to continue depending rather heavily on foreign savings to maintain the current high levels of economic growth, and so, the question of whether the current account deficit

and the external debt would threaten the country's external position becomes very important, especially when one envisions the possibility of facing reduced foreign savings.

The objective of the study was to assess the sustainability of the current account deficit and external debt sustainability. This was achieved by examining the solvency condition using Jaime De Pine's dynamic debt model in conjunction with the analysis of the external risks affecting the capital account. The model shows the ability to service debt by the path of the debt-to-export ratio through time when taking into account the evolution of the key variables such as external debt, exports, imports, and interest payments. It also provides estimates of the level of warranted exports, which is the required level of exports while maintaining the current level of imports, interest rate payments to allow the country to remain solvent.

Using Jaime De Pine's model, it was found that during 1996/97, the current account deficit and the external debt approached sustainable levels. In 1996/97, the current account deficit was at a comfortable level in the sense that the warranted exports were slightly higher than actual exports. However, the reverse has been true for the other years as exports have been much lower in comparison to the level required for maintaining current account and foreign debt sustainability. The examination of the issue of current account deficit and external debt sustainability is based on an analysis of the current account balance excluding current transfers. The inclusion of transfers in the analysis, which would be treated as a revenue source of export, would reduce the level of additional exports required to maintain current account sustainability at the same levels of imports and interest payments and external debt sustainability.

This quantitative assessment is in general consistent with the analysis of the pattern of current account financing. Uganda's current account deficit was financed mostly by public medium and long-term loans, while short-term loans were largely related to trade finance. With the levels of export growth and the low interest rates, the external debt would have been sustainable. However, this has not been possible due to the size of debt stock accumulated in the past. In addition, the comparison of the level of imports to exports shows that imports are more than twice the exports. The combination of these two factors is bound to ensure that Uganda's debt remains unsustainable if not adequately addressed. As part of addressing the problem of a high debt stock, the country qualified for HIPC debt relief through the implementation of a number of economic and structural reforms resulting in the cancellation of a part of the debt stock. In addition, a cap was placed on new external borrowing providing an optimistic view on the medium term debt sustainability although this will require a lot of restraint. Nonetheless, government should seek additional debt relief, as the debt stock remains quite high. Also attempts to conclude agreements with non-Paris club bilateral creditors who have not yet agreed to providing relief equivalent to HIPC terms should be made.

However, even as these measures are taken, some additional problems have appeared and deserve policy-makers' attention. First, debt-creating finance has accounted for the larger part of capital inflows since the lifting of controls on the capital account, and this has tendencies of raising the cost of financing the current account deficit. The related foreign direct investment flows have involved substantial loans at commercial terms. Second, as the share of private debt has increased, the total external debt has become more vulnerable to interest rate variability in international financial markets. It is also worth noting that there is also some vulnerability that could undermine further the positive impacts of trade on economic growth. Vulnerability to fluctuations in commodity prices remains since there is still heavy dependence on primary commodity exports. There is also a question about the extent of local value added.

As the cost of financing the current account deficit and the risks associated with capital account tend to rise, managing the current account deficit and external debt requires the government to monitor closely transactions on the capital account to ensure that they do not cause diverse effects to the banking sector and the economy as a whole. It is therefore critical to ensure continued macroeconomic stability, and to strengthen the efficiency and health of the banking system. It is also important to maintain a market driven exchange rate consistent with monetary and interest rate policies. However, addressing the key question related to the efficiency of capital utilization is of importance. This remains a challenge for government especially if it is to exercise fiscal discipline.

Other measures, which need to be considered, include harmonizing trade-related policy with the WTO principles, especially in narrowing the gap between domestic regulations and obligation to non-discriminatory national treatment. Furthermore, structural reforms are also necessary conditions for the required increase in domestic savings and for the development of the private sector. The capacity for export of goods and services should also be strengthened through the improvement of business competition initiatives, export diversification and the expansion of manufactured exports. At present, the export of services, especially the tourism industry are below potential, while it is also important to attract more overseas remittances, which have played a significant role in reducing the risks and extent of current account deficit.

## **V. Policy Implications for Africa**

Arising from the above findings, policies to enhance current account and external debt sustainability in Africa include the following:

### **5.1 Generating a holistic picture of the debt problem**

African countries need to improve the mechanisms for the collection of data on total debt flows. The mechanisms of debt data collection and reporting should be consistent with international best practice. Data on debt flows in a number of African countries are not comprehensive and tend to be a less reliable indicator of the overall debt burden. Comprehensive debt data is necessary for analysing the future macroeconomic effects of the country's debt obligations. One of the most critical data requirements in this regard relates to private sector external debt. It is important for countries to establish reliable information regarding private debt stocks, disbursements and the projected repayment schedules.

### **5.2 Debt strategy and regular debt sustainability analysis**

An important factor that led to the accumulation of unsustainable levels of external debt was poor debt management and imprudent borrowing practices of the debtor countries. Public sector external borrowing was not carefully managed both in terms of the amount and the terms. Borrowed resources were often used without regard to economic return and debt servicing effects in the future. To attain external debt sustainability, it is important to strengthen Africa's debt management capacity and to implement prudent policies on both non-concessional and concessional borrowing.

The debt management capacity requirements must go beyond the maintenance of proper debt records to the conduct of regular analysis of the entire debt portfolio to assess the debt sustainability and risks of the sovereign liabilities. The results of this analysis should be incorporated into the debt strategies of the respective countries.

The debt strategy should ensure that there is coordination between monetary and fiscal policies, particularly when economic shocks occur and a timely adjustment of domestic policies is effected for speedy recovery. Africa needs to pursue policies for prudent debt negotiation and debt management as well as institutionalise debt sustainability analysis into the general process of economic policy formulation. The sustainability analysis should encompass the broad question of external debt including public as well as private debt.

### **5.3 More concessional resources should be made available**

Africa requires new development financing and resource transfers to be made available over and above the traditional HIPC debt relief. Creditor and donor agencies have a primary responsibility to ensure that their previous commitments are made available. While a number of African countries have implemented sound economic and social policies resources remain insufficient in terms of magnitudes required to achieve the Millennium Development Goals (MDG's).

In order to keep the external debt situation sustainable and safeguard the current account positions of a number of African countries new external finance should be on concessional terms. African countries should however bear in mind that in sourcing for external financing, the level of concessionality of the funding is not a sufficient condition for sustainability. Large external borrowing on concessional terms could generate unsustainable positions as well. Safeguards in form of limitations on size of concessional borrowing should be built into each country's external financing policies. The policies themselves should be derived in the context of each country's debt servicing capacity and should be based on mandatory annual Debt Sustainability Analysis.

African countries will have to bear in mind that increased absorption of donor resources to finance MDGS could result in appreciation pressures that could have deleterious effects on export performance. More fundamentally, it is possible that an increase in government expenditure through donor resources could crowd out private investment<sup>18</sup>.

### **5.4 Creditors have responsibilities**

Creditor agencies should bear the responsibility of ensuring that the mix of available finance is kept in line with the debt servicing capabilities of debtor countries. Creditors need to maintain sufficient flexibility to accommodate additional financing requirements when warranted by circumstances such as external shocks and natural disasters. This would help African countries to adjust incase of shocks such as those that follow terms of trade deterioration. These shocks affect debt service capacity and tend to increase the risk of long-term sustainability of these countries, and jeopardize poverty reducing expenditures. Measures for creditor flexibility should include new financing, additional grant financing, or a temporary moratorium on debt service *vis-à-vis* bilateral creditors. Creditor nations also need to ensure that multilateral agencies are able to furnish development finance at

---

<sup>18</sup> This result can be easily seen from the familiar identity,  $Y=C+I+G+X-M$ .

appropriately concessional terms since multilateral institutions have become the largest source of loan financing for African countries.

## **5.5 Increased capacity to trade: export promotion and diversification**

The motive for promoting exports is to create capacity to finance current account requirements and meet external debt service obligations. In a number of African countries, there is need for additional efforts to achieve vertical and horizontal export diversification. Export promotion policies should be the vehicle for diversification. For many African countries import levels are a lot higher than exports creating an imbalance in trade that underscores the strategic role of exports. Sustained export growth is needed to strengthen Africa's external payment capacity and to help create additional income and resources for growth and poverty reduction. Diversifying the export base therefore, remains the best insurance against terms of trade shocks. While fluctuations in exports and terms-of-trade shocks are frequently cited as the reasons for Africa's vulnerability the continued reliance on low value primary products remains a key concern. It may be worthwhile therefore, to channel some of the debt relief funds towards financing export diversification as this positively impacts on long-term external debt sustainability. Trade also improves the welfare of those involved in the production of exports through employment creation and higher incomes. It is therefore important for Africa to overcome supply side constraints to production and increase access to markets in developed countries.

Another important implication for African countries receiving donor support is that they need to lower the domestic resource costs of production through increased investment in public goods with high import content. Critical infrastructure with high import content includes power generation equipment, water harvesting machinery and transport and communications equipment. Such imports provide a mechanism that automatically sterilizes inflows that would have exerted pressure on monetary policy and yet go a long way in reducing the cost of doing business. In a nut shell African countries should design their public expenditure programs in ways that enhance the productivity of exporting sectors. The productivity of the rural poor can also be improved through expenditure measures that increase availability of high yielding seeds or improve agronomic practices. Improved farming practices have a cost-reducing impact on production costs and on the competitiveness of the exports.

## **5.6 Prudent fiscal and consistent monetary policy management**

It is now recognised that prudent fiscal management and consistent monetary policy makes the external debt dynamics more manageable. If Africa sustains the recent improvement in its management of the macroeconomy, more stable forms of capital will be attracted. More stable economies in the continent will support development of capital markets and there will be an improvement in the efficiency with which capital is allocated. Well-managed economies will tend to attract foreign direct investment flows which are much more sustainable than the short term flows. Prudent fiscal management also implies that unjustified recourse to external borrowing is avoided.

## **5.7 Country risk and cost of business**

Heavy reliance on external debt finance arises from Africa's failure to attract sustainable levels of private investment. Private investment remains low because the environment needs to be

substantially improved to be conducive to inward as well as outward capital flows. It is important to develop institutional as well as legal frameworks that provide investors with certainty. An environment that attracts investment is vital for technology development in Africa. In turn, technology improvement is required to raise productivity in agriculture as well as in manufacturing so that countries shift from exports that are low in technology and are driven by availability of natural resources rather than labour efficiency.

Good infrastructure is important for Africa to reduce the cost of doing business, harness its productive capacity and improve export production. It is through increased exports that the region will be able to meet its external debt obligations and attain sustainable current account deficits. An improvement in domestic infrastructure is a necessary condition for the increase in the efficiency with which capital and labour are utilized. The full package of roads, electrification, telecommunication, sewerage services and water supply require due attention from government. The bottom line is that good infrastructure attracts capital and investors.

## **5.8 External debt as a regional common problem**

The debt problem in Africa has attained transboundary implications because it affects most of the countries in the region. It is therefore important to attain a regional consensus to mitigate weaknesses inherent in individual country approaches to the problem. Cooperation in a regional context is required when requesting for favourable new terms for external finance and debt servicing. It is important that Africa generates a common position to present to the international community regarding the debt sustainability question.

## **5.9 Aid absorption, governance and MDG's**

Africa needs to improve governance and accountability mechanisms surrounding external finance. In conjunction with civil society organizations the degree of transparency, including public disclosure and accountability needs to be revamped. Monitoring and negotiation processes for external finance also need to be made more transparent. Transparency is what will ensure that debtor nations access only finance that will ensure overall sustainability and is appropriate to country needs. There should be an appropriate vehicle for communicating clearly to the citizens as well as the international community the financing requirements of the country as well as the strategies needed for increased growth and poverty reduction. Improved governance also implies better management of aid inflows so that the overall productivity of public investment is increased. Institutions to increase absorption capacities of countries for donor resources are required and existing ones should be strengthened. Improved accountability and transparency will imply better value for money. Increased absorption and value for money would also lower the cost of doing business and ultimately contribute to higher factor productivity.

## **5.10 Financial reform and strong banking systems**

Strong banking systems are needed to improve intermediation in order to sustain capital inflows to Africa. Strong banking systems will increase the willingness of foreign investors to hold portfolio or fixed assets in African countries. Most importantly, reforms should be continued to provide groundwork for more robust regional stock markets in Africa.

## References

- Alessandria, G., and Quian, J. 2005. Endogenous financial intermediation and real effects of capital account liberalization. *Journal of International Economics*, 67: 97-128.
- Asiedu, E. 2004. Capital controls and Foreign Direct Investment. *World Development*, 32: 479-490.
- Berthlemy, J.C., and Soderling, L., 1999. The role of capital accumulation, adjustment and structural change for economic take off: Empirical evidence from African growth episodes, CEPIL.
- Bibangambah J.R., 2001. *Africa's quest for economic development – Uganda's experience*. Fountain Publishers.
- De Pines, Jaime. 1989. Debt sustainability and over adjustment. *World Development*, Vol. 17, No.1.
- Edwards. S., 2002. Debt relief and the current account: An analysis of the HIPC initiative, UCLA and NBER.
- Geoff., T., 2002. *Use of international investment position statistics in UK*. 5<sup>th</sup> Meeting of the IMF Committee on Balance of Payments Statistics. Canberra, Australia.
- IMF, 2005 a. Review of PRGF Program design-overview, Prepared by the Policy Development and Review Department, Washington D.C.
- IMF, 2005 b. The macroeconomics of managing increased Aid Inflows: Experiences of Low-Income Countries and Policy Implications, Prepared by the Policy Development and Review Department, Washington D.C.
- IMF, 2005 c. Monetary and fiscal policy design issues in low-income countries, Prepared by the Policy Development and Review Department, Washington D.C.
- Kaminsky, G., Lizondo, S., and Reinhart, C.M. 1997. Leading indicators of currency crises, World Bank, Washington D.C.
- Kasekende, L.A.2000. Capital account liberalization: The Ugandan experience. Overseas Development Institute.
- Kim, J.Y., and Lee, J.W., 2002. Over investment, collateral lending and economic crisis. *Japan and World Economy* 14: 181-291.
- Kraay, A and Nehru, V. 2004. When is external debt sustainable? World Bank Working Paper, Washington D.C.
- Lane, P.R., Milesi, F., and Gian., M.,2001. *Long-term capital movements*. NBER Working Paper, No. 8366.
- Malcolm, K., and Fabio, S., 1998.*Current accounts: What is their relevance for economic policy making?* IMF Working Paper No. WP/98/71.
- Sum, L., 2004. Measuring time varying capital mobility in East Asia. *China Economic Review*, 14: 181-201.
- Summers, L. 1996. Commenting, Ricardo Hausman and Liliana Rojas-Suarez eds Volatile Capital Flows, IDB.
- Thanh, V.T., Minh, D.H., Hong, T.D., and Hong, N.T., 2001.*The sustainability of the current account deficit and external debt in Vietnam*, EADN Working Paper No. 10.
- Van de Merwe., E.J., 2002. *The use of Balance of Payments in the determination of monetary and fiscal Policy*. 5<sup>th</sup> Meeting of the IMF Committee on Balance of Payments Statistics. Canberra: Australia.
- Watchel, P., 1998. *Current account balances and external debt in transition economies: lessons for Central Asia*, Research Paper presented at the 5<sup>th</sup> Anniversary of the Kyrgyz som International Conference.